OUTLOOK

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System's hybrid design utilizes "ideal characteristics" of other plan designs

SDRS, A Retirement System with a Difference

It's no coincidence that while most of the nation's retirement systems continue to struggle in the wake of the global economic crisis, SDRS is steadily regaining its financial strength. "SDRS isn't like other pension plans at all," says Laurie Gustafson. "The way it's designed and the policies it has adopted clearly set it apart from typical systems, whether they be defined benefit plans or defined contribution plans."

Gustafson explains that defined benefit plans pay retirees a set monthly amount based on a participant's final average salary, years of service and a multiplier. Except for possible cost-of-living adjustments, the payment remains the same for life.

On the other hand, defined contribution plans are like IRAs: The amount of a benefit payment is not fixed but varies depending on the size of the

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SDRS combines best features of defined benefit, defined contribution plans

The chart examines ideal characteristics to compare three types of retirement plans: defined benefit, defined contribution, and SDRS' hybrid. Sound public policy that takes both employer financial issues and employee needs into consideration is based on these characteristics.

Plan Characteristic	Defined Contribution	Defined Benefit	SDRS
Provides retirement income at lower cost		✓	✓
Generates maximum investment returns due to professional management		✓	✓
Provides continuous lifetime retirement income		✓	✓
Provides a clearly defined benefit at retirement		✓	✓
Fixed costs for employers and employees	✓		✓
Investment risk borne by employee	✓		✓
Promotes employee recruitment and retention		✓	✓
Portable (transferable with job change)	✓		✓
Advantageous to both short- and long-term employees			✓
Annual COLA		✓	✓
Survivor and disability benefits		✓	✓
Post-retirement survivor benefits			✓
Early retirement benefit		✓	✓
Lower administrative costs		✓	✓
Considers special retirement needs of judicial and public safety employees		✓	✓

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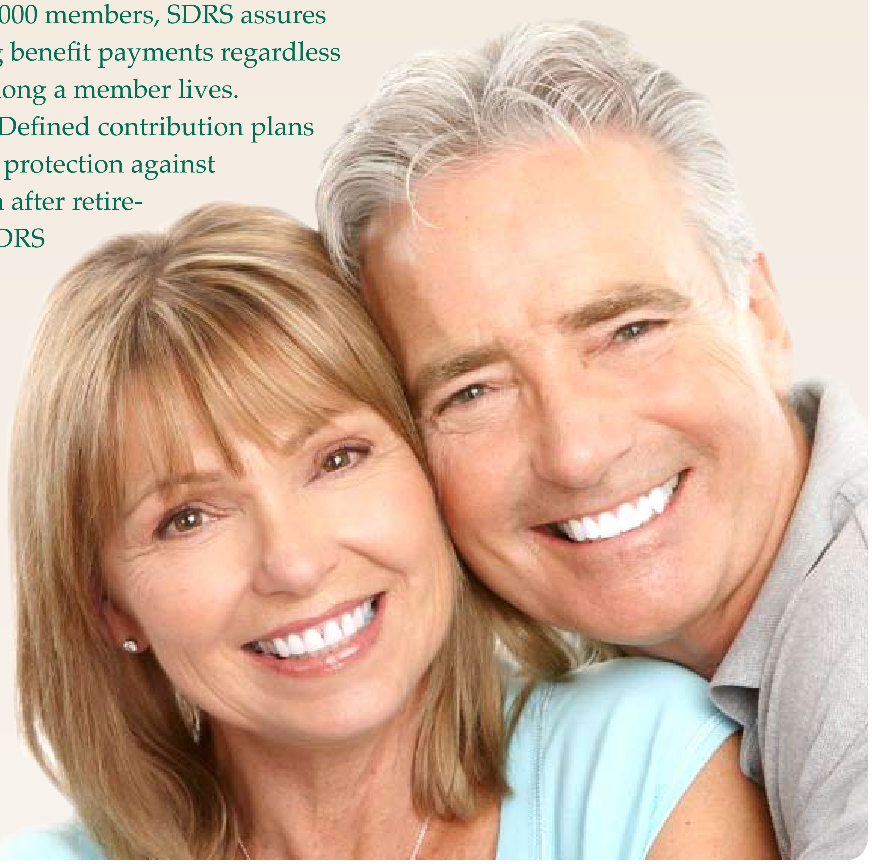
account and the investment returns that it earns. Retired participants can withdraw money whenever they choose, but each account is finite and may fail to produce adequate income or last a lifetime.

"SDRS isn't either of these kinds of plans," says Gustafson. "It's a mistake to categorize it as one type or the other." Here are some of the differences that distinguish SDRS from defined benefit and defined contribution plans.

- **Employers insulated from risk.** Defined benefit plans mandate that employers bear the burden of investment risk — if investments fall short, employers are forced to increase contributions. In SDRS, investment risk is ultimately borne by the members, employers and the plan. If events were to threaten the system's financial viability, it has been the practice of SDRS to reduce its future liabilities to bring the system back into balance.
- **Reserves to protect the system.** Defined benefit plans seldom hold adequate assets to cover the full cost of promised benefits. For SDRS, however, 100 percent funding is the norm. Moreover, before considering a benefit improvement, the system sets aside an additional 23 percent above full funding to protect the system from any investment loss. Having such a reserve reduced the impact of the global economic crisis and contributed to putting SDRS on the path to recovery quickly.
- **Professional investment management.** Defined contribution plans leave members responsible for making their own investment decisions. Consequently, defined contribution plans typically earn lower-than-average investment returns. In contrast, SDRS' professionally managed trust fund substantially out-performs average returns.
- **Volatility risk.** Retired participants in defined contribution plans are exposed to short-term investment losses which could force the selling of assets at distressed rates to cover living expenses. Because SDRS has a large membership, it is able to mitigate individual risk by absorbing short-term volatility and maintaining its benefit stream.
- **Continuous payments for life.** Defined contribution plans may not be adequate to last a member's lifetime, especially as life expectancies increase. By spreading benefit costs over 75,000 members, SDRS assures life-long benefit payments regardless of how long a member lives.
- **COLA.** Defined contribution plans offer no protection against inflation after retirement. SDRS provides its members a minimum annual increase in benefits of 2.1 percent. In years when the system is fully funded, the cost of living adjustment jumps to 3.1 percent.
- **Plan portability.** Defined benefit plans do not allow their members to take their assets with them if they leave their job. But vested SDRS members leaving public employment after three years can withdraw all of their contributions and 85 percent of their employer's contributions, plus interest.
- **Conservative approach to benefit improvements**. Many defined benefit plans improve benefits and hope that future investment earnings will pay for them. SDRS always prepays any improvement it makes for its members. That means the cost is fully calculated and funded before the system recommends an increase.

For SDRS, 100 percent funding is the norm.



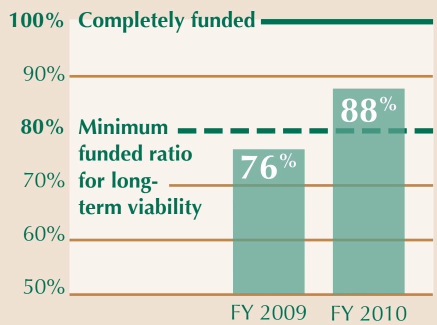
Exceptional investment earnings improve funded ratio

SDRS Recovery Among Best in Nation

A 2010 survey of public retirement plans found that, on average, systems had 65 percent of the dollars necessary to pay the benefits promised to members. While that's a significant improvement from a year ago, it's still below the minimum 80 percent funded ratio considered essential for a system's long-term viability. "This average obscures the condition of some of the most troubled retirement plans which are less than 50 percent funded," says Doug Fiddler, SDRS consulting actuary.

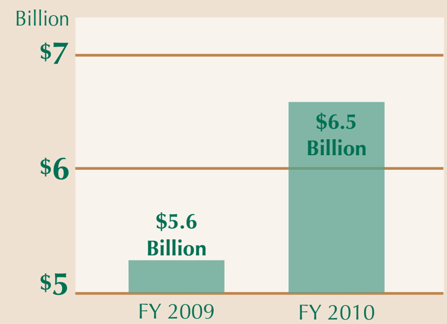
In contrast, by the end of FY 2010, SDRS had risen from a 76 percent funded ratio to an 88 percent ratio. "That's a remarkable improvement in 12 months," says Fiddler, "especially given that the economy was still sluggish. If the capital market maintains year-to-date gains, we'll see additional improvements by the end of FY 2011."

System's funded ratio rises above 80% minimum



To be considered financially viable over the long term, a retirement system's funded ratio (the comparison of its assets to obligations) must exceed 80 percent. Investment earnings returned SDRS to a funded ratio of 88 percent in FY 2010.

2010 investment earnings boost value of assets held in trust



Three factors distinguish SDRS' recovery: fundamental financial strength and resiliency, quick action protecting the system and exceptional investment performance.

The difference between SDRS and the rest of the nation's retirement systems is attributable to three major factors.

- **Financial strength prior to the crisis.** SDRS had virtually no unfunded liabilities because of its sound funding policies, which include paying for all benefit improvements in advance. In addition, before the crisis the system had 1.2 billion dollars set aside in a reserve in anticipation of lower-than-expected investment returns. This fundamental strength gave the system unusual resilience and a boost to swift recovery.
- **Quick action to reduce future liabilities.** The SDRS Board and the state Legislature acted aggressively to protect the system. Tying the amount of future cost-of-living adjustments (COLA) to the financial strength of SDRS and to the rate of inflation reduced the system's long-term liabilities. The change still provides a full 3.1 percent COLA when the system is fully funded and a minimum 2.1 percent COLA even during major economic downturns.
- **Exceptional investment performance.** The South Dakota Investment Office generated returns of nearly 19 percent in FY 2010. That was more than 7 percent above benchmarks and boosted the SDRS trust fund by $850 million.

Evaluation compares SDRS to peers

National Study Cites SDRS' Better Service, Lower Operating Costs

A 2010 study found that SDRS provides a superior level of service to its members at an exceptionally low cost. Carried out by an independent firm, the evaluation compared the quality and cost of SDRS' member services to other public retirement systems throughout the country.

Key services examined in the evaluation included

- paying benefits
- managing buy-ins, transfers and refunds
- providing pension benefit estimates
- contacting, counseling and communicating with members

Despite being less than three quarters the average size of other systems in the study and thus lacking the benefit of scale, SDRS received a total service score of 80, seven points above the peer median score of 73. "SDRS' total administration cost was 65 percent of what other systems spend," says SDRS Board member Cathy Druckrey. "That score ranks SDRS as a top performer when it comes to keeping costs down."

In the four years since the preceding evaluation, SDRS improved member services by an average of four points per year. The average annual rate of improvement among other systems was 1.3 points.

The evaluation was conducted by the international company CEM Benchmarking, Inc. Participation allows SDRS to gauge the effectiveness of its member services and measure the value provided for the administrative costs expended. As a result, SDRS is able to identify service areas in which to focus additional resources and to share ideas and best practices with other pension systems.

Fiscal effect on system insignificant

2011 Bills Focus on Veterans, Child Beneficiaries

The SDRS Board of Trustees recommended three measures for the South Dakota Legislature to consider in 2011. None of the measures would significantly affect the system's fiscal condition.

The broadest of the measures, HB 1022 revises certain provisions regarding veterans' credited service and benefits. The bill

- adds a provision that allows a member returning from military duty to SDRS employment for less than one year to receive credit for time spent on duty, if member and employer contributions are made to SDRS for the period of duty. SDRS will continue to grant service credit for military duty without contributions if the member works at least one year upon return.
- establishes that the status of an SDRS member killed or disabled while on active duty is as if that member had returned to work one day before the event.
- allows members on military leave to withdraw funds from their Supplemental Retirement Plan accounts without terminating employment.

Signed by the Governor, the three bills will take effect on July 1, 2011.

HB 1023 clarifies how disability and family benefits are handled in regard to children. It is a codification of common-sense practices already in place.

The third bill, HB 1024, updates procedures for filling vacancies on the Board of Trustees.

The three bills passed both houses of the state Legislature and have been signed by the Governor. They will take effect on July 1, 2011. Descriptions of the bills can be found at http://www.sdrs.sd.gov/legislative/.

Increase set by 2010 law

COLA Boosts SDRS Benefits by 2.1 Percent on July 1, 2011

SDRS' cost-of-living adjustment (COLA) will increase benefit payments by 2.1 percent in the upcoming fiscal year, which begins July 1, 2011.

The rate of increase is determined by a South Dakota law passed in 2010. The law links the COLA to the system's funded status during the previous year and the rate of inflation. Because SDRS' funded status — its ratio of obligations to assets — was 88 percent at the close of the past fiscal year, the rate of the COLA would equal inflation but be no less than 2.1 percent.

Since the Consumer Price Index (CPI), the federal government's measure of inflation, rose less than 1 percent over the past year and remained under the indexed level of two years ago, SDRS will increase the COLA by the minimum amount set by law, 2.1 percent. This is in contrast to the policy governing cost-of-living adjustments for Social Security: When there is no increase in the CPI from previous years, no COLA is applied to Social Security benefits.

When SDRS' funded status returns to 100 percent, the COLA will increase benefits by 3.1 percent regardless of the rate of inflation.

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employee and employer contributions and supported by investment returns. The vast majority of the dollars come from the investments that the trust fund makes, which enables employee and employer contributions to remain reasonable and stable over time.

I'm also referring to the system's administrative costs – the costs of providing services to the system's members. I think what is so outstanding about SDRS is that even with exceptionally low costs, the system provides above-average service to its members.

Outlook: Do you know how SDRS ranks among other plans in delivering services to its members?

Druckrey: In 2010 a private firm audited the quality of SDRS' member services and the cost of their delivery. The audit considered a wide range of performance indicators, from how many seconds SDRS takes to answer the phone to how quickly new retirees start to receive their benefits. It graded how up-to-date SDRS keeps member statements and benefit estimates. It investigated Web site features that offer members secure access and provide retirement planning tools. SDRS outscored its peers in 13 of the 16 categories evaluated in the audit. That achievement indicates that the quality of SDRS' member services is very high.

SDRS outscored its peers in 13 of the 16 categories evaluated in the audit.

But just as impressively, the report showed SDRS' costs for administering those services to be only about 65 percent of the mean expended by its peers.

Outlook: You said SDRS members make contributions equal to employers. Is that the norm?

Druckrey: It's not the norm. Typically employers make larger contributions than members and sometimes members make no contributions at all.

Outlook: What else do professionals mention when talking about SDRS as a model plan?

Druckrey: Often they point to how differently SDRS is designed. Contrary to SDRS' practices, many retirement systems increase benefits without having assets on hand to fund them. Some systems place the risk of poor investment performance entirely on employers. Other systems assign the complex and risky task of investing to members, causing them to grapple with the real possibility of running out of money in their later years.

Few plans provide portability to short-term employees. SDRS is built to incorporate the positive features of other plans while avoiding their negative aspects. If SDRS continues to follow this roadmap, I see a very strong and stable outlook in the years to come.

Outlook is produced to communicate the plan provisions, changes in law, and issues of interest to the members of the South Dakota Retirement System. It is published with funds provided through the contributions of teachers, school boards, state government, state employees, county commissions, county employees, municipal governments, and municipal employees. 65,000 copies of this document were printed on recycled paper by SDRS at a cost of 16 cents per document.

SDRS

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"SDRS is a remarkably low-cost system when compared to other public employee plans."

Cathy Druckrey

OUTLOOK *Interview*

SDRS is frequently cited as one of the leading public retirement systems in the nation. Numerous aspects set SDRS apart — everything from below-average employer contribution rates to above-average benefit payments, from low operational costs to delivery of exceptional member services. Board member Cathy Druckrey talks about what truly puts SDRS on top of the retirement system mountain.

Outlook: Articles in the national press often rank SDRS as one of the best public retirement plans in the nation. What does that really mean?

Druckrey: Frequently there's a lot of confusion about what characteristics a model retirement plan should include. When SDRS is cited as among the best, the speaker is usually referring to the structure of its benefits and its hybrid design, as well as its funded status and the governing polices and practices of the system.

Outlook: So "best" does not imply that the system pays the biggest benefits?

Druckrey: Some people only relate to the benefit structure of a plan, so there is a tendency to think that best means "benefits." However, in the industry, "best" includes not only the plan's benefits but also its funded status, both past and current, and takes into account the costs associated with running the plan. SDRS is a remarkably low-cost system when compared to other public employee plans.

Outlook: When you say SDRS is a low-cost system, what do you mean?

Druckrey: I'm referring to the entire cost of the system. SDRS provides retirement, disability and survivor benefits all under one plan that is funded equally by

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